Financial Management

Report on the Review of the Development of the DoD Baseline for Military Equipment
(D-2005-112)

Department of Defense
Office of Inspector General

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Acronyms

FMR	Financial Management Regulation
PMO	Program Management Office
SFFAS	Statement of Federal Financial Accounting Standards

September 30, 2005

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION,
TECHNOLOGY AND LOGISTICS/ACQUISITION
RESOURCES AND ANALYSIS
UNDER SECRETARY OF DEFENSE
(COMPTROLLER/CHIEF FINANCIAL OFFICER)

SUBJECT: Report on the Review of the Development of the DoD Baseline for Military
Equipment (Report No. D-2005-112)

We are providing this report for your information and use. The Director of
Acquisition Resources and Analysis in the Office of the Under Secretary of Defense for
Acquisition, Technology, and Logistics provided comments. We considered
management comments on the draft report when preparing the final report. The complete
text of the comments is in the Management Comments section of this report.

We appreciate the courtesies extended to the staff. Questions should be directed
to Ms. Barbara A. Sauls at (703) 325-5782 (DSN 221-5782) or Mrs. Alice F. Carey at
(703) 325-6839 (DSN 221-6839). The team members are listed inside the back cover.
For the report distribution, see Appendix D.

By direction of the Deputy Inspector General for Auditing:

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Department of Defense Office of Inspector General

Report No. D-2005-112   **September 30, 2005**
(Project No. D2005-D000FH-0033.000)

Review of the Development of the DoD Baseline for Military Equipment

Executive Summary

Who Should Read This Report and Why? This report is intended for use by officials in the Property and Equipment Policy Office (Policy Office) in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics. The report discusses the results of the agreed-upon procedures Office of Inspector General auditors performed.

Background. The DoD must comply with government accounting standards, including Statement of Federal Financial Accounting Standard No. 23, "Eliminating the Category of National Defense Property, Plant, and Equipment," May 2003, which requires DoD to include the cost of its military equipment on the DoD Balance Sheet. To comply with the new standard, the Office of Secretary of Defense is developing and implementing a Business Enterprise Architecture conceptual model[*] that describes the business processes and system requirements DoD believes are needed to accurately value, depreciate, and financially report military equipment. The first phase of the conceptual model, the baseline valuation, is primarily a manual effort to determine the historical cost for military equipment acquired as of September 30, 2006.

This is the first of two reports about the methodology the Policy Office is developing to determine the value of all military equipment. This report discusses the agreed-upon procedures, the auditor actions, and the results of those actions. The second one will discuss significant auditor findings, conclusions, and recommendations.

Results. The Policy Office requested that we perform procedures to review the methodology developed to accurately identify and value all military equipment. The Policy Office intended the process to identify and value military equipment to satisfy financial statement requirements that changed how military equipment is reported. We coordinated with the Policy Office and jointly developed agreed-upon procedures to review the methodology. The procedures reviewed four primary areas: the military equipment universe, program valuation, program valuation waivers, and DoD decision makers' information needs.

To evaluate the completeness of the military equipment universe, we executed a very limited test, which showed that known programs were included in the universe. The Policy Office expanded the universe after they provided the initial data to the Office of Inspector General. Although our review did not identify any excluded programs, we determined that the Policy Office had not developed a process to validate the completeness of the military equipment universe.

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[*] The Business Enterprise Architecture conceptual model describes business processes that will be required to support the new accounting treatment for military equipment, system interfaces that may be required to support the new accounting treatment for military equipment, and system requirements to support the new accounting treatment for the military equipment and business processes.

Our review of 48 programs and subprograms showed that the Policy Office had completed valuations for 19 programs or subprograms and waived 29 programs or subprograms. All 19 programs or subprograms with completed valuations had deficiencies. We reviewed the waiver process for the remaining 29 programs and determined that 12 of those programs or subprograms lacked sufficient documentation to support their waiver status.

To determine if the baseline methodology satisfied the needs of DoD decision makers, we distributed questionnaires among 42 program office points of contact. The 19 timely questionnaire responses indicated that the baseline information did not adequately address program office information needs.

Management Comments. Although not required to comment, the Director, Acquisition Resources and Analysis disagreed with the audit determinations that:

- the Policy Office approach did not include a process to validate that the universe contained all military equipment;

- the valuation team was incorrect in its treatment of some program end items, but believed that it warranted study; and

- the questionnaire responses did not adequately address program office information needs and would be used primarily for financial reporting purposes.

Auditor Response. We believe that the process of reviewing the universe list with program managers and using information from military equipment accountability and maintenance databases should be considered part of the process to identify programs, not a process to validate the completeness of the universe. We agreed with the Director's assessment that performing additional analysis on this program and similar programs is reasonable and would be beneficial. Further, we believe that the personnel at the program offices were the only DoD decision makers that had any significant exposure to the results of the military equipment valuation and distributing the survey to other decision makers would not have been logical or beneficial. See the Overview section of the report for a discussion of the management comments and the Management Comments section of the report for the complete text of the comments.

Management Actions. During the engagement, we developed and submitted to the Policy Office three issue papers discussing the lack of source documentation, concerns with the update methodology, and deficiencies found in one of the methods used to account for modifications. Additionally, we discussed the issue involving the lack of program manager attestations with the Policy Office. In response, the Policy Office began implementing corrective actions to resolve the issues. Specifically, the Policy Office began holding meetings with Defense Finance and Accounting Service field offices to determine the availability of historical cost documentation. Additionally, the Policy Office revised the baseline update methodology and prepared a draft position paper that described a revised methodology to value modifications. The Policy Office also incorporated an assertion requirement into the valuation process.

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Independent Auditor's Report

Overview

In response to the President's Management Agenda, the Under Secretary of Defense (Comptroller) established a DoD goal of achieving a clean audit opinion. To meet this objective, DoD must comply with government accounting standards, including Statement of Federal Financial Accounting Standards (SFFAS) No. 23, "Eliminating the Category National Defense Property, Plant, and Equipment," May 2003, which requires DoD to include the cost of its military equipment on the DoD Balance Sheet. To comply with the new standard and move toward obtaining a clean audit opinion, the Office of Secretary of Defense is developing and implementing a Business Enterprise Architecture conceptual model that describes the business processes and system requirements DoD believes it needs to accurately value and depreciate military equipment and report it on financial statements. The first phase of the conceptual model, the baseline valuation, was primarily a manual effort to determine the historical cost for military equipment acquired as of September 30, 2006.

The Property and Equipment Policy Office (Policy Office) in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics requested that we perform procedures to review the methodology developed to accurately identify and determine the value of all military equipment. We performed procedures agreed upon by officials in the Policy Office and the Office of the Inspector General. The sufficiency of these procedures is solely the responsibility of the Policy Office officials. Therefore, we make no representation regarding the sufficiency of the procedures. We used the procedures to review the methodology that the Policy Office used to develop a baseline approach for valuing military equipment as of September 30, 2006. Specifically, we applied the procedures to the military equipment universe, program valuation, program valuation waivers, and DoD decision makers' information needs. If we had performed additional procedures, other reportable matters might have come to our attention. However, we were not engaged to and did not perform an audit with the objective of expressing an opinion on the methodology, on the accuracy of the data collected using the methodology, or both. Therefore, we are not expressing an opinion. We implemented the agreed-upon procedures in accordance with generally accepted government auditing standards and standards established by the American Institute of Certified Public Accountants as of April 15, 2005.

This is the first of two reports on the methodology developed by the Policy Office to value all military equipment. This report discusses the agreed-upon procedures, auditor actions, and results. The second one will discuss significant auditor findings, conclusions, and recommendations. We developed and submitted three issue papers addressing the lack of source documentation for recently acquired military equipment, concerns with the update methodology, and deficiencies found in one of the methods used to account for modifications. In response, the Policy Office stated it was working towards resolving the issues. Specifically, the Policy Office began holding meetings with Defense Finance and Accounting Service field offices to determine the availability of historical cost documentation. The Policy Office also revised the baseline update methodology

and provided us a new position paper describing a revised methodology to value modifications.

Military Equipment Universe. The Policy Office intended the process to identify and value military equipment to satisfy financial statement requirements that changed reporting of military equipment from "National Defense Property, Plant, and Equipment" to "General Property, Plant, and Equipment." The Policy Office hired KPMG, an accounting firm, to help develop the baseline valuation methodology for valuing military equipment. KPMG stated that they collected military equipment program data and Military Services' points of contact information, reviewed relevant data sources, and established a preliminary military equipment program universe list, as of June 2003. The sources included the following.

- 363 Reports[1]

- Procurement Programs (P-1)[2]

- Selected Acquisition Reports[3]

- Government Accountability Office Defense Acquisition Assessments of Major Weapon Programs[4]

Using this approach, along with validating and reviewing the universe list with program executive officers, program managers, and Component points of contact, the Policy Office believed it captured all significant military equipment programs and modifications to those programs. However, the approach did not include a process to validate that the universe contained all military equipment. The effort to identify all visible and known military equipment programs was ongoing and, according to the Policy Office, the universe had grown to 1,108 programs as of September 15, 2005.

To evaluate the completeness of the universe, we asked program executive officers, program managers, and Component points of contact to identify additional, less recognizable programs that were not included. In our limited test, we submitted a questionnaire to 42 program office points of contact and asked whether they managed any military equipment programs excluded from the military equipment valuation universe (see Appendix C, question 10). We received 19 timely responses; however, only 18 provided responsive answers to this question. Fourteen of the 18 replied that they did not manage any military programs other than those on the list. Only four responders identified military

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[1] According to the Policy Office, the 363 Report is a compilation of individual Military Service reports reflecting the inventory of major end items of military equipment.

[2] According to the Policy Office, the Procurement Programs (P-1) is derived from and consistent with the Comptroller Information System database. The P-1 line items represent funding for active procurement programs per budget year.

[3] According to the Policy Office, Selected Acquisition Reports summarize the latest estimates of cost, schedule, quantities, and technical status for major defense acquisition programs.

[4] According to the Policy Office, the Government Accountability Office Defense Acquisitions Assessment of Major Weapons Programs report provides an assessment of DoD programs and identifies potential risks.

programs as not included in the universe. Further review showed that those programs were actually included in the universe. Consequently, our test did not identify any excluded programs.

Program Valuations. On August 27, 2004, KPMG provided a list of 858 programs, which included 326 completed reviews, 149 in-process reviews, and 383 scheduled reviews. We judgmentally selected a sample of 22 programs from completed evaluations and from additional programs identified during our September 2004 site visit. Eight of the programs included subprograms; therefore, we increased our sample by adding 26 subprograms for a total sample size of 48 programs and subprograms.

The Policy Office had determined values for 19 of the 48 programs and subprograms. We identified issues in all 19 valuations. Some of our areas of concern include:

- historical cost documentation

    - acquisition and disposal dates

    - costs and expenditures

- accounting for modification costs

- judgments made by the valuation team

- baseline target date

- documentation of program manager agreement with the valuations

  Historical Cost Documentation. The valuation methodology did not use historical cost documentation when it was available. The methodology calculated the program valuations based on data obtained from various financial, acquisition, and logistics systems. Although that methodology would have been proper if obtaining initial historical costs was not practical, it was improper (according to SFFAS No. 23) when historical cost documentation should have been available. As defined by DoD Regulation 7000.14-R, "DoD Financial Management Regulation (FMR)," volume 4, chapter 6, "Property, Plant, and Equipment," August 2000, supporting documentation includes:

- purchase invoices,

- sales and procurement contracts,

- DD Form 1354 "Transfer and Acceptance of Military Real Property,"

- ENG Form 3013 "Work Order/Completion Report,"

- construction contracts, and

- work orders generated independently of the entity in possession of the property.

The Federal Acquisition Regulation, National Archives and Records Administration, and DoD FMR require that historical cost data be available for military equipment contracts for 6 years and 3 months after final payment. SFFAS No. 23 was effective for accounting periods beginning after September 30, 2002, which was within the required retention period of 6 years and 3 months. Therefore, military equipment acquired after the effective date of SFFAS No. 23 required that programs retain historical cost supporting documentation.

Acquisition and Disposal Dates. Historical records should have been used to establish equipment acquisition dates for 10 of the 19 sample programs and subprograms that received valuations because equipment was acquired within the FY 2003 and FY 2004 accounting periods. However, all 10 of those programs and subprograms used acquisition dates obtained from financial, acquisition, and logistics systems without reconciliation with required historical documentation, such as invoices or work order completion reports. Similarly, historical records should have been used to establish equipment disposal dates for 2 of the 19 sample programs and subprograms because equipment was disposed of within the FY 2003 and FY 2004 accounting periods. For those two subprograms, the Policy Office did not have sufficient source documentation to support the date of disposal.

Costs and Expenditures. Historical records should have been used to establish program costs and expenditures for 16 of the 19 sample programs and subprograms because they occurred during the FY 2003 and FY 2004 accounting periods. However, for those 16 programs and subprograms, the Policy Office did not provide supporting documentation.

Accounting for Modifications. The methodology used to capitalize and depreciate modification costs in 4 of the 19 sample programs and subprograms did not comply with SFFAS No. 6, "Accounting for Property, Plant, and Equipment," June 1996, as amended; the DoD FMR; and the Policy Office's proposed business rules on modifications, modernizations, and upgrades. Instead, the valuations added the modification costs to the program's original acquisition costs in order to average the modification costs across all of the program's end items. As a result, the valuations assumed that all of the program's end items had been modified when a number of end items had not been modified. Further, the valuations capitalized and depreciated the modification beginning with the period the Program Management Offices (PMOs) placed the first end item in service, which may not be the period in which the expenditure for the modification occurred. Therefore, the methodology the Policy Office used for the three program valuations was not in compliance with Generally Accepted Accounting Principles. As a result, the estimated net book value may be misstated.

During the engagement, we informed the Policy Office of the issue we found with the method used to account for some modifications. In response, the Policy Office provided a draft position paper that described a revised methodology to value modifications. The Office of Inspector General has reviewed the revised policy and has provided comments. If the Policy Office accounts for modifications using the methodology discussed in its revised policy, it should adequately resolve the issues. We will revisit this issue when the Department has implemented the revised policy.

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Valuation Team Judgments. According to an analysis performed by Government Accountability Office auditors, the valuation team selected the ground control stations as the primary end item for the Predator Unmanned Aerial Vehicle Program and allocated total system development cost and expenditure data on the basis of the number and expected life of the control systems. In fact, the program procured end items for aircraft and control stations with such various useful lives, cost, count, and susceptibility to disposal to presumably warrant treatment as independent subprograms. A more reasonable approach would be to allocate the costs between different parts or subprograms of the program. Because the valuation team had selected the control stations as the primary end item, the program valuations would not recognize aircraft loss, which is both more likely and more costly. The valuation team for the Tactical Automated Security System Program inappropriately calculated a portion of program values using an average unit cost obtained from a sample of contracts. Because the program incurred costs during a time when SFFAS No. 23 required the use of historical costs, calculated averages derived from a sample of contracts was unacceptable.

Baseline Update. The completed preliminary valuations and those program valuations that remained to be completed will require additional updating as of September 30, 2006. Additional work will be required to update the valuations because DoD does not have financial and accountability systems that would provide accurate and timely information. To overcome these challenges, the Policy Office proposed an update solution that would require program information from organizations beyond its direct control. Specifically, substantial assistance will be required from the Defense Finance and Accounting Service, the PMOs, the Military Department Financial Management Components, and the Naval Space and Warfare Systems Center. Although the proposed update solution might be logical if DoD had more time, the aggressive baseline date may not allow adequate time for the update methodology's development and implementation.

Program Manager Attestations. The program managers were not required to indicate written concurrence or non-concurrence with program valuations. Because we considered program managers as the best source to accurately evaluate military equipment costs, we suggested that program managers sign attestations of concurrence with their programs' military equipment valuation calculations. The Policy Office agreed with our recommendation and, as a result, agreed to request that program managers sign attestations beginning in FY 2005. However, the attestation template that KPMG provided in November 2004 did not address whether the program manager concurred with the program valuation. Therefore, program managers are still not required to attest[5] to concurrence or non-concurrence with program valuations.

Program Valuation Waivers. The program managers signed program waivers for 29 of the 48 programs and subprograms from our judgmentally selected sample. For 12 of the 29 program waivers that KPMG and the Policy Office accepted, the waivers lacked adequate documentation to support their waiver status.

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[5] Attest means to affirm to be true or to authenticate by signing as a witness.

Program Office Information Needs. According to the Federal Accounting Standards Advisory Board, DoD decision makers need program information regarding budgetary integrity, operating performance, stewardship, and systems and control. In order to determine whether the baseline adequately addressed these needs, we distributed 42 questionnaires to a judgmentally selected sample of 32 PMO points of contact and, additionally, asked that 10 of those PMOs forward our questionnaire to their respective Program Executive Offices. We received and reviewed 19 timely questionnaire responses.

   Information Needs Not Met. The questionnaire responses indicated that the baseline did not adequately address program office information needs and would be used primarily for financial reporting purposes. Generally, the responders indicated the following.

- Program valuations did not provide access to new or improved information.

- Program valuations, based on program averages over the entire life of the program, did not provide information at a useful level.

- Depreciation was not useful in making managerial decisions.

- More accurate and consistent accounting and accountability systems would be more useful.

Only 16 of the 19 questionnaire responders provided responsive answers to the question that addressed the usefulness of a validation of the estimated useful life. Eight of the 16 responders indicated that a validation of the estimated useful life of military equipment would be useful[6] (see Appendix C, question 9). Additionally, when asked whether they agreed with the Policy Office's calculated program valuations (see Appendix C, question 2), two responders provided additional comments that indicated that program valuations could be more useful. One of those responders indicated that the information might be more accurate if they considered program costs such as development, modification, operation, and support costs. However, the responders did not indicate that the program valuations were not in compliance with any DoD policy or accounting standards by omitting these program costs

   Information Needs Met. At least two responders did indicate that program valuations met some information needs. One responder stated that program valuations may be useful to decision makers in the Office of the Secretary of Defense or Congress who are further removed from programs. Another responder indicated that the program valuation provided a new depreciation valuation.

Management Comments and Auditor Response

Management Comments. Although not required to, the Director of Acquisition Resources and Analysis commented, stating that the growth of the military

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[6] The number of questionnaire responders differs from the number of responses per specific question because some responders did not respond to every question.

equipment universe is evidence that the Policy Office has a process to validate the completeness of the universe. The Director stated that before the baseline valuation effort, the Department did not have a single source for identifying military equipment programs. The Director stated that her office believes its process of data accumulation and review included sufficient data sources and procedures for ensuring the completeness of the military equipment universe.

Auditor Response. The growing number of programs in the universe does provide evidence that the process to identify programs has been ongoing. However, it does not provide evidence that the Policy Office has a process to validate the completeness of the universe. Reviewing the universe list with program managers and using information from military equipment accountability and maintenance databases should be considered part of the process to identify programs; however, we do not believe it is an effective process to validate the completeness of the universe. A process to validate the completeness of the universe might include selecting a sample of military equipment used in the field and tracing it to the accountability systems or the universe.

Using its current process, the Policy Office had identified 858 programs as of August 27, 2004, 1074 programs as of February 28, 2005, 1090 programs as of May 16, 2005, and the number of programs in the military equipment universe continues to grow, as would be expected when developing the universe. However, this process, which originally did not identify hundreds of programs, cannot be considered adequate for validating the completeness of the universe. The Policy Office should not assume that because a process appears adequate for developing a universe, it is also adequate for validating that the universe developed is complete. The process to validate the completeness of the universe should ensure that all military equipment units were included in the balance sheet.

Management Comments. The Director stated that her office does not believe that the valuation team was incorrect in treating the Predator Unmanned Aerial Vehicle Program end item as a total system. The Director stated that her office believes that the valuation of this and similar programs warrants study, given the subject's complexity and applicability to more than a single military equipment program. The Director stated that her office will research the subject and recommend an approach for identifying and accounting for such programs.

The Director also stated that her office believes that the Office of Inspector General survey missed the point of the military equipment valuation effort. The Director stated that because the Policy Office used data that the Project Managers provided to establish the military equipment baseline, it was understandable that the program managers would see no value added. The Director stated that the military equipment valuation project was oriented toward decision makers at higher echelons. She said that the project provides standard, consistent data on programs that can be used for decision making, but no senior leaders were surveyed for the report. The Director stated that she expects the value of the military equipment effort to increase as it moves from the program level to the asset level.

Auditor Response. We disagree with the Director's comment that the survey missed the point of the military equipment valuation effort because it was distributed to program office personnel but not senior leaders. The personnel at the program offices were the main DoD decision makers that had any significant

exposure to the results of the military equipment valuation. Therefore, distributing the survey to other decision makers would not have been logical or beneficial. Further, in the report we noted that program valuations might be useful to senior leaders in the Office of the Secretary of Defense or Congress who are further removed from programs.

The Director stated that it was understandable that program managers would see no value added because they already possess the information. However, the Director stated in an earlier response that before the baseline valuation effort, the Department did not have a single source for identifying military equipment programs. The baseline valuation effort presents the Policy Office an opportunity to provide the program managers, who make the day-to-day decisions for the programs, with a single source of information that would be useful and readily accessible.

Agreed-Upon Procedures, Auditor Actions, and Results

We performed the baseline valuation methodology procedures agreed upon by the Policy Office and the Office of Inspector General. This section contains the agreed-upon procedures, the auditor actions, and the results of accomplishing those procedures as of April 15, 2005.

Procedure. Evaluate the process used by the Policy Office to identify the universe of military equipment.

Auditor Action. We reviewed the methodology that the Policy Office implemented to ensure the completeness of the military equipment universe. We held discussions with key personnel from the Policy Office. We obtained a written description from the Policy Office about the approach used in the universe development. We obtained a list of sources that the Policy Office used to develop the initial military equipment program universe. Additionally, we obtained the list of programs included in the military equipment universe as of August 27, 2004.

We reviewed the Universe Construction Source Reference Descriptions[7] provided by KPMG. We identified the significant sources of supporting documentation for the sample programs. We examined the sources that are common to all the Military Departments and those sources that are unique to each Department. We evaluated the logic of the process used by KPMG to ensure that all military equipment programs were valued and then we evaluated the reasonableness and reliability of the sources.

Because the Policy Office was still developing the program universe, we could not perform a full completeness test. However, we performed a limited completeness test within our judgmental sample. We requested that the program managers identify any military programs that were excluded (omitted but not as part of a waiver) from the Policy Office's military equipment valuation effort. We reviewed those programs identified as omitted from the universe and determined that all were actually included in the universe.

Results. Program Managers did not identify any programs excluded from the universe and our limited testing of the program universe did not identify missing programs. However, we noted that the Policy Office methodology did not include a process to validate the completeness of the military equipment universe.

Procedure. Review the baseline valuation methodology developed by the Policy Office to report military equipment values.

Auditor Action. We obtained introductory briefing charts on the baseline valuation methodology developed by the Policy Office to report military equipment values. We also obtained the baseline business rules.

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[7]The KPMG descriptions were a compiled list of primary sources used to develop the initial military equipment program listing.

We analyzed the standard valuation model developed by the Policy Office and KPMG and questioned the methodology for capitalizing and depreciating modification costs. We met with the Policy Office and discussed possible methods of addressing modification costs.

We reviewed the proposed baseline valuation update methodology for reasonableness. We identified issues with the update methodology.

We accompanied the Policy Office and KPMG on five site visits to observe the military equipment valuation process. We prepared a draft overview of the process and submitted the overview to the Policy Office for comment.

We reviewed the Office of the Secretary of Defense, Policy Office briefing charts and business rules.

Results. Based on our reviews and observations, we developed and submitted three issue papers addressing the lack of source documentation, concerns with the update methodology, and deficiencies in the baseline approach. In response, the Policy Office stated they were working towards resolving the issues. Specifically, the Policy Office began holding meetings with Defense Finance and Accounting Service field offices to determine the availability of historical cost documentation. The Policy Office also revised the baseline update methodology and provided a new position paper describing a revised methodology to value modifications.

Procedure. Review and determine the reasonableness of the military equipment valuations that the Policy Office had completed.

Auditor Action. We reviewed the standard valuation model to determine how the Policy Office had calculated the valuations. Then we judgmentally selected a sample of 22 programs from 326 programs with reviews completed by the Policy Office and also from programs identified during our September 2004 site visit. We noted that the sampled programs also contained subprograms. Therefore, we modified our judgmental sample by selecting 26 additional subprograms within our primary sample. As a result, our sample included 48 military equipment programs and subprograms. We reviewed supporting documentation for the appropriation and expenditure data, asset quantity data, and useful life. We identified that the Policy Office had completed program valuations for 19 of the 48 programs and subprograms.

Results. We identified problems with all 19 program valuations. Those problems included unsupported acquisition and disposal dates, unsupported program costs and expenditures, incorrect accounting for modification costs, and unacceptable judgments made by the valuation team.

Procedure. Review the waiver criteria the Policy Office used to exclude projects from the valuation process to determine the reasonableness of the exclusion.

Auditor Action. We held discussions with key personnel from the Policy Office and its contractor, KPMG. We also attended program review debriefings conducted by KPMG with some PMOs. We obtained copies of the waiver criteria. We identified 11 types of waivers and summarized pertinent criteria for issuing a waiver valuation exemption.

Results. In our judgmental sample, 29 of the 48 programs and subprograms received waivers; however, 12 of the 29 programs and subprograms did not have sufficient data to support a waiver.

Procedure. Determine whether the baseline that the Policy Office was developing for military equipment adequately addressed DoD decision makers' needs.

Auditor Action. We reviewed Federal Accounting Standards Advisory Board guidance[8] about the objectives of Federal financial reporting. Using this guidance as a basis, we listed the DoD primary decision makers as program managers and executives and we identified their major information needs as budgetary integrity, operating performance, stewardship, and systems and control. We performed a limited needs test within our judgmental sample. We distributed a questionnaire to 42 program office points-of-contact addressing whether the baseline met their information needs. We reviewed 19 timely responses and summarized the replies.

Results. The responses indicated that the information offers limited usefulness for program office decision making and would be primarily useful on financial reporting.

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[8] "Objectives of Federal Financial Reporting Statement of Federal Financial Accounting Concepts Number 1," September 2, 1993. The guidance classifies users of financial information about the Federal Government in four major groups: citizens, Congress, executives, and program managers. Their needs are categorized in four broad categories: budgetary integrity, operating performance, stewardship, and systems and control.

Appendix A. Scope and Methodology

The Policy Office requested that DoD Office of Inspector General auditors perform procedures to review the methodology developed by the Policy Office to accurately identify and value all military equipment. The Policy Office wanted DoD Office of Inspector General involvement during the development and implementation process to identify potential auditable issues. The Policy Office believed that identifying those issues earlier in the military equipment valuation process would provide an opportunity to confront and correct them before DoD submits an assertion package[9]. Officials in the Policy Office and Office of Inspector General discussed and agreed upon procedures for the engagement. Specifically, the agreed-upon procedures included evaluating whether the valuations of military equipment and the waiver criteria used to exclude programs from the valuation process were reasonable . The agreed-upon procedures included evaluating whether the military equipment universe was complete and reviewing whether the baseline adequately addressed DoD decision makers' information needs. The Office of the Inspector General with the assistance of the Government Accountability Office performed these agreed-upon procedures in accordance with generally accepted government auditing standards and standards established by the American Institute of Certified Public Accountants as of April 15, 2005.

Scope Limitations. We performed this review from October 2004 through March 2005 in accordance with generally accepted government auditing standards. The agreement limited our scope to agreed-upon procedures that did not include tests of management controls. Therefore, we limited our scope and judgmentally selected and reviewed 48 programs and subprograms to evaluate the effectiveness of the proposed methodology to value military equipment. During the program and methodology reviews we identified process deficiencies and provided three issue papers to the Policy Office.

Use of Computer-Processed Data. We relied on computer-processed data provided directly from the Policy Office and KPMG that was extracted from numerous DoD financial, acquisition, and logistics systems to evaluate sample program valuations and waivers. Specifically, we used the computer-processed data to review program valuation calculations, examine supporting documentation adequacy, and analyze waiver appropriateness. We did not determine the reliability of the computer-processed data. Not evaluating the controls did not affect the results of the applications of the agreed-upon procedures.

Government Accountability Office High-Risk Area. The Government Accountability Office has identified several high-risk areas in DoD. This report provides coverage of the Defense Financial Management high-risk area.

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[9] An assertion package is prepared by DoD management to notify the DoD OIG that a financial statement or line item is ready for audit.

Appendix B. Prior Coverage

During the last 5 years, the Government Accountability Office, the DoD Inspector General and the U.S. Army Audit Agency have issued 8 reports discussing military equipment. Unrestricted GAO reports can be accessed over the Internet at http://www.gao.gov. Unrestricted DoD OIG reports can be accessed at http://www.dodig.mil/audit/reports.

GAO

Report No. GAO 04-910R, "Financial Management: Further Actions Are Needed to Establish Framework to Guide Audit Opinion and Business Management Improvement Efforts at DoD," September 20, 2004

Report No. GAO 04-615, "DoD Business Systems Modernization: Billions Continue To Be Invested With Inadequate Management Oversight and Accountability," May 2004

DoD IG

DoD IG Report No. D-2004-092, "Corps of Engineers Equipment Reporting on Financial Statements for FY 2003," June 22, 2004

DoD IG Report No. D-2003-117, "Systems Inventory to Support the Business Enterprise Architecture," July 10, 2003

DoD IG Report No. D-2001-011, "Prior Period Adjustment to Remove National Defense Property, Plant, and Equipment," November 16, 2000

Army

U.S. Army Audit Agency Report No. A-2003-0139 "National Defense Equipment Reporting," February 6, 2003

U.S. Army Audit Agency Report No. A-2002-0238-FFG "Audit of The Army's FY 01 General Fund Financial Statements-General Equipment," March 13, 2002

U.S. Army Audit Agency Report No. AA2001-225, "Audit of the Army's Inventory and Control of Military Equipment," April 6, 2001

Appendix C. Questionnaire Responses

Questionnaire Responses of Program Office POCs					
Question	**% of Actual Responses Yes[1]**	**% of Actual Responses No[1]**	**Yes**	**N o**	**Unresponsive or N/A Answer**
1. Do you have a clear understanding of the Office of the Secretary of Defense (OSD) methodology for valuing military equipment?	71	29	12	5	2
2. Do you agree with the OSD calculated program valuations?	70	30	7	3	9[2]
3. Is the level of valuation information, which is based on program averages over the entire life of the program, useful to manage or report on your programs?	25	75	4	12	3
4. Do the OSD program valuations provide you with access to new information to use in managing and reporting on your program?	27	73	3	8	8
5. Do the OSD program valuations provide you with access to improved information to use in managing and reporting on your program?	27	73	3	8	8
6. Would precise information without any estimates on the historical cost of military equipment programs be useful in making managerial decisions?	69	31	11	5	3
7. Would precise information on allocated military equipment program costs (depreciation) based on actual, not estimated, useful life be helpful in making managerial decisions?	18	82	3	14	2
8. Are there any additional program valuation requirements that needed to be addressed, but were not in OSD program valuations?	23	77	3	10	6
9. Do you believe it would be useful for DoD to validate the program's estimated useful life?	50	50	8	8	3
10. Do you manage any military programs that were excluded (omitted but not as part of a waiver) from the OSD military equipment valuation effort?	22	78	4[3]	14	1
11. Do you believe that increased accuracy and consistency in feeder systems (accounting and accountability systems) would be useful to manage and report on your programs?	65	35	11	6	2
[1]Percentages apply to the number of responsive answers per specific question. [2]Seven of the nine stated they could not respond because they had not been debriefed/given their program valuations. [3]The programs identified as omitted by the four responders were actually included in the universe.					

Appendix D. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics
    Director, Acquisition Resources and Analysis
Under Secretary of Defense (Comptroller)/Chief Financial Officer
    Deputy Chief Financial Officer
    Deputy Comptroller (Program/Budget)

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Finance and Accounting Service

Non-Defense Federal Organization

Government Accountability Office

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Homeland Security and Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform

House Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform
House Subcommittee on National Security, Emerging Threats, and International Relations, Committee on Government Reform
House Subcommittee on Technology, Information Policy, Intergovernmental Relations, and the Census, Committee on Government Reform

Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics Comments

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ACQUISITION
TECHNOLOGY
AND LOGISTICS

JUL 1 3 2005

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDITING,
DEFENSE FINANCIAL AUDITNG SERVICE

SUBJECT: Response to Draft Report on the Review of the DoD Baseline for Military
Equipment (Project No. D2005FH-033.000)

The following is in response to the subject report. In our response to your Draft Report on Development of the DoD Baseline for Military Equipment (D2005FH-033.001), we addressed many of the observations and conclusions discussed under the heading "results" in the subject report. Consequently, our comments which follow are limited to matters not previously addressed. Our comments concern observations in the following areas:

- Military Equipment Universe
- Valuation Team Judgments
- Program Office Information Needs

Military Equipment Universe

Observation: The draft report states that the "...Policy Office believed it captured all significant military equipment programs and modifications to those programs. However, the approach did not include a process to validate that the universe contained all military equipment."

Response: As stated in the draft report, the Property and Equipment (P&E) Policy Office used numerous reports that contain information on military equipment acquisition programs to identify the military equipment universe. Further, the draft acknowledged that the effort was on-going and that the universe of programs identified by the effort has grown, which is evidence that there in fact is a process to validate the completeness of the universe.

Prior to the baseline valuation effort, a single source of military equipment programs did not exist. In response, the P&E Policy Office identified primary points of contact within each Military Service for the purpose of identifying data sources for defining the universe of military equipment programs and associated end items.

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The process used to define and validate the universe of military equipment programs and end items included a review of data gathered from the following reports and actions.

Department-Wide Data Sources

- Section 363 Report[1]
- Comptroller's Information Systems Database - P-1 Budget Line Item Reports
- Selected Acquisition Reports (SAR)
- Government Accountability Office Acquisition Assessments of Major Weapons Systems Programs

Component-Specific Data Sources

Air Force
- SAF AQ Military Equipment Listing
- Air Force System Extracts (Accounting and Accountability), for example
  - Reliability and Maintainability Information System (REMIS)
  - Air Force Equipment Management System (AFEMS)
- Program Management Office Briefings and Overview Documents

Navy and Marine Corps
- Navy and Marine Corps RD&A Database
- Marine Corps Systems Command Listing
- Navy and Marine Corps System Extracts (Accounting and Accountability), for example
  - Naval Vessel Registry (NVR)
  - Aircraft Inventory Readiness Report (AIRRS)
  - Logistics Management Information System (LMIS)
  - Navy Research, Development, and Acquisition (RD&A) Database
- Program Management Office Briefings and Overview Documents

Army
- Army Weapon System Books (2003 and 2004)
- CFO Equipment Listing (LOGSA Data Extract)

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[1] On October 5, 1999, Congress passed Public Law 106-65, National Defense Authorization Act for Fiscal Year 2000, Section 363, "Report on Inventory and Control of Military Equipment." The law required the Secretary of Defense to submit a one-time report, by Military Department, addressing the inventory and control of military equipment. The Committees on Armed Services of the Senate and the House of Representatives were to receive the reports by August 31, 2000. The report was to address the military equipment status as of the end of fiscal year 1999. Public Law 106-65 required the Inspector General, Department of Defense, to review the report submitted to the committees and submit any comments considered appropriate by November 30, 2000. DoD actually issued the report on March 6, 2001, based on reporting for FY 2000 instead of FY 1999. The report identified 643,254 military equipment assets. These assets have an estimated value of about $700 billion.

- Army RD&A Database (Acquisition Information Management System (AIM))
- Army System Extracts (Accounting and Accountability), for example
  - Logistics Support Activity (LOGSA)
  - Acquisition Information Management Database (AIM)
- Program Management Office Briefings and Overview Documents

We believe that the foregoing data accumulation and review effort includes sufficient data sources and procedures for ensuring the completeness of the military equipment universe. To further minimize the risk of program omission, we inquire of program managers as to whether they are responsible for programs other than the ones we have identified as being administered by their office. In addition, using information from military equipment accountability and maintenance databases, the P&E Policy Office is tying end item inventories to program data to determine that program valuation data is in evidence for all end items.

Valuation Team Judgments

Observation: According to an analysis performed by the Government Accountability Office auditors, the valuation team incorrectly treated the Predator Unmanned Aerial Vehicle program end items as a total system. In fact, the program primarily procured end items for aircraft and control stations with such various useful lives, cost, count, and susceptibility to disposal to presumably warrant treatment as independent subprograms. Additionally, the valuation team should have selected the aircraft and not the control stations as the primary end item in the total systems approach.

Response: We do not believe that the valuation team was incorrect in treating the Predator Unmanned Aerial Vehicle program end item as a total system. However, we believe that the valuation of this and similar programs warrants study given the subject's complexity and applicability to more than a single military equipment program. Accordingly, we will research the subject and recommend an approach for identifying and accounting for such programs.
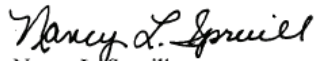
Program Office Information Needs

Observation: According to the Federal Accounting Standards Advisory Board, DoD decisionmakers need program information regarding budgetary integrity, operating performance, stewardship, and systems and control. In order to determine whether the baseline adequately addressed these needs, we distributed 42 questionnaires to a judgmentally selected sample of 32 PMO points of contact and, additionally, asked that 10 of those PMO's forward our questionnaires to their respective Program Executive Offices. We received 19 timely questionnaire responses. The questionnaire responses indicated that the baseline did not adequately address program office information needs and would be used primarily for financial reporting purposes.

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Response: We believe this survey missed the point of the military equipment valuation effort. In establishing the military equipment baseline, the P&E Policy Office is using data provided by Program Managers. Therefore, it is understandable that Program Managers would see no value added, given it is information they already possess. Because Program Managers already have this information for their own program, this project is oriented towards decision makers at higher echelons who are responsible for making comparisons between programs across the enterprise. This project supplies, for the first time, standard, consistent data on programs that can be used for decision-making. Yet, no senior leaders were surveyed for your report. As the valuation of military equipment moves from program level to asset level, we would expect that its value for Program Managers as well as senior decision makers will increase.

If you have any questions about this memorandum, please contact Mr. Richard Sylvester, Deputy Director (ARA), Property and Equipment Policy Office, at (703) 604-6350 or Richard.Sylvester@osd.mil.

Nancy L. Spruill
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